

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:RFP:CHI:2:POSTF-149746-01

MJCalabrese

date: Dec 19, 2001

to: Manager, [REDACTED]  
LMSB: [REDACTED]

from: Associate Area Counsel (LMSB), Chicago

---

subject: Opinion - Worthless Stock Loss and Check the Box Deemed Liquidation

Taxpayer: [REDACTED]

This memorandum responds to your office's request for assistance. We have consulted with Foreign Joint Ventures Industry Counsel Sergio Garcia-Pages with respect to certain of the matters herein. This memorandum should not be cited as precedent.

**ISSUES**

1. Whether the facts involving the taxpayer's [REDACTED] establish entitlement to an I.R.C. § 165(g) worthless stock loss.

2. Whether certain transfers of interests in foreign subsidiaries should be ignored or recharacterized because of a possible tax avoidance purpose.

**CONCLUSIONS**

1. The facts do not establish that the taxpayer is entitled to claim a § 165(g) worthless stock loss.

2. The transfer of interests in foreign subsidiaries should not be ignored or recharacterized because of a possible tax avoidance purpose.

**FACTS**

[REDACTED]

Pursuant to the check the box provisions, [REDACTED] elected partnership status for its [REDACTED].

A deemed liquidation of the entity occurred on [REDACTED].

[REDACTED] contends that the stock of the [REDACTED] became worthless in the period ending September 30, [REDACTED]. With respect to the stock of the [REDACTED], the taxpayer on its return claimed an I.R.C. § 165(g) worthless stock loss in the amount of \$[REDACTED]. The taxpayer has since revised its US basis in the stock to \$[REDACTED].

Corporate records prior to [REDACTED] show that the taxpayer owned [REDACTED]% of the [REDACTED] subsidiary. The Schedule K-1 on a partnership return for fiscal year ending September 30, [REDACTED] shows that [REDACTED], a [REDACTED] corporation, owned [REDACTED]% of the [REDACTED]. The final organizational chart for the taxpayer's fiscal year [REDACTED] also shows the [REDACTED] subsidiary owning [REDACTED]% of the [REDACTED].

The assets of the [REDACTED] had an appraised value of \$[REDACTED]. The company had liabilities of \$[REDACTED], resulting in debt exceeding assets by \$[REDACTED]. Of its original debt, the [REDACTED] owed \$[REDACTED] to other [REDACTED] affiliates and \$[REDACTED] to other entities. Since claiming the worthless stock loss, the [REDACTED] has continued as a profitable business.

[REDACTED]

Pursuant to the check the box provisions, [REDACTED] elected partnership status for [REDACTED], a [REDACTED] subsidiary. The election resulted in a [REDACTED] deemed liquidation of the [REDACTED].

[REDACTED] first determined a \$[REDACTED] loss resulting from the deemed liquidation of the [REDACTED]. The taxpayer determined that the [REDACTED] had a value of \$[REDACTED], and was owned [REDACTED]% by [REDACTED] (a US affiliate of the taxpayer), [REDACTED]% by [REDACTED] (another [REDACTED] affiliate), and [REDACTED]% by [REDACTED], a [REDACTED] entity. The ownership percentages were based upon capital contributions.

Using [REDACTED], the taxpayer revised its valuation of the [REDACTED] to \$[REDACTED]. This time, based upon stock ownership percentages, the taxpayer said that the [REDACTED] was owned [REDACTED]% by [REDACTED], [REDACTED]% by [REDACTED], and [REDACTED]% by [REDACTED]. On [REDACTED], [REDACTED] acquired stock in the [REDACTED] resulting in its

ownership percentage increasing above █%.

Using █, the taxpayer determined a second revised value of \$ █ for the █. The valuation also states that consideration of excess liabilities results in the █ having no value, with liabilities exceeding assets by \$ █.

█, a █ Holding Co.

Pursuant to the check the box provisions, the taxpayer elected partnership status for █, its █ holding company. This resulted in a █ deemed liquidation of the █ holding company.

The taxpayer estimated an \$ █ value for the █ company and a deemed liquidation loss of \$ █. With respect to the █ company, the taxpayer at first determined that █ owned █% of the stock and █, owned █%. The taxpayer later determined that the █ company was owned █% by █, █% by █, and █% by █. Later yet, this time based upon ownership of voting preferred stock, the taxpayer said the █ company was owned █% by █, █% by █, and █% by █. The taxpayer also revised its basis determinations, and concluded that it experienced US losses of \$ █, with \$ █ allocated to █ and \$ █ allocated to █.

A reorganization agreement dated █ shows authorized shares in the █ company. It authorizes █ ordinary shares and █ ordinary preferred and █ ordinary and █ ordinary preferred.

An undated document entitled █ authorizes █ "█" preferred ordinary shares at █ each, █ "█" ordinary shares at █ each, and █ redeemable preference shares at █ each. "█" stockholders receive one vote per share. "█" stock has no voting rights. Holders of redeemable preference stock are allowed one vote per thousand shares. The New Articles of Association provides that upon liquidation, surplus assets are distributed first to holders of redeemable preference shares in an amount equal to the paid subscription price per share, including any premium.

**ANALYSIS****1. The I.R.C. § 165(g) worthless stock loss**

I.R.C. § 165(g)(1) allows a capital loss for any capital asset security that becomes worthless during the taxable year. "Security" is defined to include i) a share of stock in a corporation, ii) a right to subscribe for or to receive a share of stock, or iii) certain evidences of indebtedness. I.R.C. § 165(g)(2). Allowance of the loss requires a showing i) of the taxpayer's basis in the stock and ii) that the stock became worthless in the taxable year. Figgie International, Inc. v. Commissioner, 807 F.2d 59, 62 (6th Cir. 1986), aff'd T.C. Memo. 1985-369; Murray v. Commissioner, T.C. Memo. 2000-262.

[REDACTED] elected partnership status for its [REDACTED] effective [REDACTED]. On its return for the period ending September 30, [REDACTED], [REDACTED] first claimed a \$ [REDACTED], and then an \$ [REDACTED], [REDACTED] worthless stock loss.

The [REDACTED] has continued to operate. The business is profitable. The taxpayer contends that as of [REDACTED], the [REDACTED] had assets of \$ [REDACTED] and liabilities of \$ [REDACTED]. The [REDACTED] owes a large majority of its debt to other [REDACTED] affiliates.

Determining the worthlessness of stock is a factual question that examines pertinent facts and circumstances. Boehm v. Commissioner, 326 U.S. 287, 292 (1945); Lincoln v. Commissioner, 24 T.C. 669, 694 (1955) (the question of worthlessness "is to be determined by a practical common sense consideration of all the evidence"). A taxpayer needs to show both worthlessness and the taxable period in which the stock became worthless. Lincoln v. Commissioner, 24 T.C. at 694. Generally, the loss should be fixed and established by a closed and completed transaction or by reference to "identifiable events". Id. at 694.

Present value and potential future value are both considered in determining whether stock has become worthless. Rev. Rul. 77-17, 1977-1 C.B. 44. If liquidation value shows no present or current worth, potential future value must still be considered. Future value accounts for foreseeable benefits to be realized from the future operations of the corporation. Morton v. Commissioner, 38 B.T.A. 1270, 1278 (1938) aff'd, 112 F.2d 320 (7th Cir. 1940). On this point the tax court in Morton said as follows:

[S]tock may not be considered as worthless even when having no liquidating value if there is a reasonable hope and expectation that it will become valuable at some future time . . . .

The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidation value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. If the assets of the corporation exceed its liabilities, the stock has a liquidation value. If its assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has a potential value and can not be said to be worthless. The loss of potential value, if it exists, can be established ordinarily with satisfaction only by some "identifiable event" in the corporation's life which puts an end to such hope and expectation.

38 T.C. at 1278-79.

In this case, [REDACTED] simply elected partnership status for the [REDACTED]. The deemed liquidation is not an identifiable event that put an end to any reasonable hope and expectation that the stock will become valuable in the future, even if the taxpayer can show that the [REDACTED] subsidiary's liabilities exceeded assets. We understand that the business continued as before. A decision to continue to operate a business is evidence that its stock has value<sup>1</sup>. The assets of the Mexican company were not scheduled to be sold, and its business plan did not contemplate discontinuation.<sup>2</sup> [REDACTED] (b)(5)(AC)

, (b)(5)(AC)

---

<sup>1</sup> Though, the continued operation of the business, by itself, is not sufficient to establish future value. Steadman v. Commissioner, 50 T.C. 369, 378 (1968) aff'd, 424 F.2d 1 (6th Cir. 1970); Emhart Corporation v. Commissioner, T.C. Memo. 1 (1998).

<sup>2</sup> See Austin Co. Inc. v. Commissioner, 71 T.C. 955 (1979) where the court determined that stock had no potential value where the corporation had ceased operations, had binding contracts to sell all of its assets, and was otherwise winding up its affairs.

, (b)(5)(AC)

, (b)(5)(AC)

## 2. Valuation

The values claimed for the entities changing classification have a direct relationship to the tax benefits claimed by the taxpayer. With respect to [REDACTED]'s check the box elections, the entity valuations changed over time, generally resulting in lower values, thereby increasing losses. We understand that you are working with an engineer to determine correct valuations. The engineer, a valuation expert, should provide crucial input as to the merits of the various valuation techniques employed by the taxpayer. (b)(5)(AC)

(b)(5)(AC)

## 3. Manipulating Ownership Percentages to Obtain Loss Deductions

The taxpayer's records contain conflicting information as to ownership of the [REDACTED]. Most records show that the [REDACTED] was owned [REDACTED]% by the taxpayer or one of its US affiliates. However, the last organizational chart for the taxable year and a partnership return both show [REDACTED], a [REDACTED] corporation, owning [REDACTED]% of the [REDACTED]. The taxpayer may be attempting to set up facts to provide a basis for claiming a deemed liquidation loss resulting from the check the box election.

With respect to [REDACTED], the taxpayer's revised valuations resulted in changes in ownership percentages for the [REDACTED] entity. The first valuation had the taxpayer and US affiliates owning [REDACTED]% of the [REDACTED]. The first and presumably the second revised valuations had [REDACTED] owning [REDACTED]% of the [REDACTED] as a result of interests acquired on [REDACTED] ([REDACTED] days before the deemed liquidation).

The taxpayer's revised valuations for [REDACTED], the [REDACTED] holding company, also resulted in purported changes in ownership percentages. The various computations showed the taxpayer's [REDACTED] subsidiary owning [REDACTED]%, [REDACTED]%, and [REDACTED]%, with each valuation showing US affiliates owning the balance. It is not clear from the facts whether tax considerations may have motivated the changes in percentage ownership of the [REDACTED] holding company. However, the revised valuations also showed increased basis by the US owners, resulting in a larger US loss claimed upon the deemed liquidation.

Pursuant to I.R.C. § 332, a taxpayer recognizes no gain or loss upon liquidation of a subsidiary if i) the taxpayer possesses at least 80% of the total voting power of the subsidiary stock and ii) the stock possessed by the taxpayer constitutes at least 80% of the total value of all the subsidiary stock. I.R.C. §§ 332 and 1504(a)(2). The taxpayer recognizes gain or loss upon the liquidation of a corporation in which the taxpayer has an interest if the taxpayer fails to meet either the 80% voting test or the 80% value test.

With respect to the [REDACTED] and [REDACTED], the taxpayer may have changed ownership percentages in an attempt to qualify for I.R.C. § 332 loss treatment. With respect to both foreign entities, the facts suggest that the taxpayer attempted to decrease US ownership to below 80% shortly before the check the box election.

The timing of the ownership changes suggests a tax motivation on the part of the taxpayer. Substance over form principles and the step transaction doctrine sometimes allow the Service to ignore or recast tax motivated transactions. However, the step-transaction doctrine generally does not apply when a taxpayer engages in transactions to acquire or dispose of subsidiary stock in order to fall within or outside the 80% voting and value requirements. The IRS (in certain rulings) and courts have allowed corporations to take steps to obtain tax benefits not otherwise available under I.R.C. §§ 332 and 1504(a)(2) (and their predecessors).

In Commissioner v. Day & Zimmermann, Inc., 151 F.2d 517 (3d Cir. 1945) the taxpayer owned more than 80% of each of two corporations. The taxpayer wanted to liquidate the corporations and realize losses thereon. The taxpayer's treasurer purchased a sufficient number of shares to drop the taxpayer's interest in each of the corporations to below 80%. The court allowed the taxpayer to recognize losses upon the subsequent liquidations.

In Avco Manufacturing Corporation v. Commissioner, 25 T.C. 975 (1956) the taxpayer sold some shares of stock it owned in a subsidiary in order to avoid the nonrecognition of loss rules. The court found the sale effective and concluded that the taxpayer could recognize a loss upon the subsequent liquidation. The tax motivation and a lack of a business purpose for the sale did not require the court to ignore the sale for purposes of determining the tax consequences of the subsequent liquidation.

In Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956) the taxpayer Granite Trust Co. wanted to liquidate its subsidiary Building Corporation. The taxpayer sold 20.5% of the

Building Corporation stock. Shortly thereafter it liquidated Building Corporation. The taxpayer admitted that it sold 20.5% of the stock to a friendly party in order to obtain the tax benefit of loss recognition. The taxpayer admitted that the purchaser of the stock knew of the plan to liquidate Building Corporation before the end of the year.

The court held that a purpose to avoid taxes is not an illicit motive. Granite Trust Co. v. United States, 238 F.2d at 675. The court rejected the government's attempt to apply the step transaction doctrine, noting that the Code had specific requirements for the nonrecognition of gain or loss upon liquidation. Failure to meet one of the rigid requirements, such as 80% ownership, resulted in recognition of gain or loss.

The court also found support for its position in the legislative history of I.R.C. § 332. Section 332 corresponded to § 112(b)(6) of the 1939 Code. Section 112(b)(6) included a second condition for nonrecognition of gain or loss. In enacting § 332, Congress retained the 80% voting and value requirement, but eliminated the second condition. With respect to eliminating the second condition, the Report of the Senate Finance Committee stated that the "committee has removed this provision with the view to limiting the elective features of the section". Granite Trust Co. v. Commissioner, 238 F.2d at 676, quoting Sen. Finance Committee Report, H.R. 8300, 83rd Cong., 2d Sess. 255 (1954). The court found that the language in the committee report shows a legislative understanding "that taxpayers can, by taking appropriate steps, render the subsection applicable or inapplicable as they choose, rather than be at the mercy of the Commissioner on an "end-result" theory." 238 F.2d at 676. The court interpreted the legislative history as recognizing the ability of a taxpayer to elect either recognition or nonrecognition treatment by adjusting its percentage holdings in a subsidiary prior to liquidation. For purposes of § 332, it is permissible for a taxpayer to engage in a series of transactions designed to achieve a specific end result.

The tax court also has found the recognition/nonrecognition rules of I.R.C. § 332 "elective". It has said "we conclude that section 332 is elective in the sense that with advance planning and properly structured transactions, corporations should be able to render section 332 applicable or inapplicable." Riggs v. Commissioner, 64 T.C. 474, 489 (1975), acq. 1976-2 C.B. 2. In Riggs the taxpayer corporation took steps to increase its ownership of a subsidiary to meet the 80% requirements of I.R.C. § 332. The taxpayer's subsequent liquidation of the subsidiary produced nonrecognizable gain.

Rev. Rul. 78-285, 1978-2 C.B. 137 cites with approval Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956). In the facts of the revenue ruling, a shareholder unconditionally sold to an unrelated buyer a number of shares sufficient to reduce the taxpayer's interest in the corporation below the 20% limitation that existed in I.R.C. § 341(e)(4)<sup>3</sup> at the time. With respect to a transaction occurring a few days later, the Service recognized the sale as reducing the shareholder's holdings in the corporation to below 20% for purposes of applying I.R.C. § 341(e)(4). The revenue ruling recognizes an ability on the part of a taxpayer to plan in advance and structure transactions in such a way as to render a Code section applicable or inapplicable.

The Service has treated § 332 similarly, as indicated in (non-precedential) letter rulings and a field service advice.<sup>4</sup> Though non-precedential, the letter rulings and FSA reflect a reasoning that would apply in this case. See Ltr. Rul. 8428006 where the IRS, citing Granite Trust, permitted the "absolute, unconditional, non-contingent, and unrestricted" sale of 33⅓% of the stock of a wholly owned subsidiary, where the parent corporation sold the stock to avoid § 332(a) nonrecognition of loss treatment upon the subsequent liquidation of the subsidiary. See also FSA 200148004, 2001 TNT 232-15 where the Service allowed the taxpayer to reduce ownership interests in a foreign entity to below 80% in order to obtain recognition of loss treatment upon a check the box deemed liquidation.

In this case, [REDACTED] claims changes in the stock ownership of its foreign entities resulting in less than 80% US ownership. The claims are based on various revised valuations for the foreign entities. The Service's engineer must review the valuations and assess the merits of the methods and numbers used by the taxpayer. However, we do not believe that the changes in ownership, to the extent they were formally proper and effective, should be ignored by the Service. Proper changes in ownership

---

<sup>3</sup> In 1986, P.L. 99-514, § 631(e)(6)(A) deleted this provision. Rev. Rul. 95-71, 1995-2 C.B. 323, obsoleted Rev. Rul. 78-285.

<sup>4</sup> Private letter rulings may not be used or cited as precedent. I.R.C. § 6110(k)(3). Some courts have said that PLRs may be used "as evidence of administrative interpretation", Commerica Bank, N.A. v. U.S., 93 F.3d 225, 230 (6<sup>th</sup> Cir. 1996) or "when evaluating the consistency of application of statutes", Phi Delta Theta Fraternity v. Commissioner, 887 F.2d 1302, 1308 (6<sup>th</sup> Cir. 1989).

would be a permissible means of obtaining desired treatment under I.R.C. § 332.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions on this matter, please call Michael Calabrese of this office at (414) 297-4241.

Steven R. Guest  
Associate Area Counsel (LMSB),  
Chicago

By: \_\_\_\_\_  
MICHAEL J. CALABRESE  
Attorney

cc (by e-mail only):

Harmon Dow, Associate Area Counsel (IP), Chicago  
Barbara Franklin, Senior Legal Counsel (LMSB), National Office  
Sergio Garcia-Pages, FJV Industry Counsel, Miami  
Steven Guest, Associate Area Counsel (LMSB), Chicago  
James Lanning, Area Counsel (LMSB), Chicago  
William Merkle, Associate Area Counsel (SL), Chicago